

VZCZCXRO2769
PP RUEHLH RUEHPW
DE RUEHIL #0238/01 0351336
ZNR UUUUU ZZH
P 041336Z FEB 09
FM AMEMBASSY ISLAMABAD
TO RUEHC/SECSTATE WASHDC PRIORITY 1292
INFO RUEHBUL/AMEMBASSY KABUL 9756
RUEHLO/AMEMBASSY LONDON 9568
RUEHNE/AMEMBASSY NEW DELHI 4385
RUEHKP/AMCONSUL KARACHI 0981
RUEHLH/AMCONSUL LAHORE 6678
RUEHPW/AMCONSUL PESHAWAR 5602
RUEAIIA/CIA WASHDC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RUEHRC/DEPT OF AGRICULTURE WASHINGTON DC
RHEBAAA/DEPT OF ENERGY WASHINGTON DC
RUEKJCS/JOINT STAFF WASHINGTON DC
RHEHNSC/NSC WASHINGTON DC
RUEKJCS/SECDEF WASHINGTON DC
RUMICEA/USCENTCOM INTEL CEN MACDILL AFB FL

UNCLAS SECTION 01 OF 02 ISLAMABAD 000238

SENSITIVE
SIPDIS

E.O. 12958: N/A

TAGS: [EFIN](#) [ECON](#) [ETRD](#) [EAID](#) [PGOV](#) [PREL](#) [PK](#)

SUBJECT: PAKISTAN STANDBY ARRANGEMENT: SO FAR SO GOOD, BUT
TROUBLE COULD BE BREWING

¶11. (SBU) Summary: IMF and Ministry of Finance contacts agree that, based on preliminary indications, Pakistan has performed well in fulfilling IMF performance criteria as required in Pakistan's November 24 Standby Arrangement (SBA).

After retiring \$1.24 billion in debt, borrowing from the State Bank of Pakistan is lower than projected and the fiscal deficit is reduced, thanks to the IMF's \$3.6 billion cash injection. Signing the Standby Arrangement has stabilized economic performance: capital outflows are down and inflation has leveled off (but not appreciably decreased), in part reflecting lower fuel prices. Finance contacts warned, however, that contradictory goals within the program itself could make it difficult for Pakistan to continue to meet benchmarks. End Summary.

So Far, So Good

¶12. (SBU) IMF ResRep Paul Ross told Econoff in mid-January that he was "cautiously optimistic" about Pakistan's performance vis-a-vis commitments undertaken in the GOP's November 24 Standby Arrangement. Stressing that data received thus far were preliminary, Ross said he felt reasonably confident that the GOP has met IMF benchmarks for borrowing from the State Bank of Pakistan (SBP) for budgetary support and foreign exchange reserves. The exchange rate has been relatively stable since December and deposits have started flowing back into the banking system. Ross said that the GOP had "worked hard" to contain the fiscal deficit in December but, without the actual GOP expenditure data, he could not be sure of the size of the deficit.

¶13. (SBU) On structural benchmarks, Ross said the GOP's contingency plan to deal with problem banks was almost ready, and that plans for tax administration reform were also being developed. Calling efforts to broaden the tax base an "acid test" for the GOP, Ross was less confident that the unified voices of the GOP economic team could outweigh the political clout of the entrenched, untaxed segments of the economy that have thwarted these reforms "for the last 20 years."

¶14. (SBU) Ross's assessment of GOP performance on subsidy reform was mixed. Fuel subsidies have already been eliminated, and the GOP is actually making windfall profits from taxes on fuel, as international prices fall but

importers and distributors have been slow to pass on lower prices to consumers. Electricity subsidies (due to be eliminated by June 2009) will be much more difficult to tackle, however. Earlier efforts to begin reducing electricity subsidies were only partially implemented and then abandoned in the face of an angry popular response to higher bills and the ongoing loadshedding.

But Trouble Could Be Brewing

¶ 15. (SBU) Special Secretary of Finance, Dr. Ashfaque Hasan Khan, told Post on January 20 that he largely agreed with the IMF's assessment of GOP performance thus far. However, Khan had several worries for the second half of the 2009 Pakistani fiscal year that ends June 30. He pointed out that the Fund's program requires Pakistan to increase tax collection from \$16.2 billion to \$17.6 billion at the same time as it imposes a one percent limit on the rate of import growth. Although tighter monetary policy will now help restrict the flow of imports, to compensate for skyrocketing import growth in July and August, Pakistan will have to achieve negative imports in the coming months to meet the IMF's one percent growth target. As almost half of GOP tax revenue comes from customs duties on imports, Khan is skeptical that the GOP could meet its revenue-collection goal -- already a weak point for the GOP. (Comment: Khan's comments are predicated on no changes in the tax structure. If the GOP raised taxes on other things, like agriculture income, they would not depend so heavily on customs duties. End Comment)

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¶ 16. (SBU) Khan was also concerned with the IMF goal of a \$6.4 billion increase in the money supply in FY 2009. With the government prohibited from increasing its borrowing from the SBP and investment lagging, Pakistan must rely on growth in private sector credit to achieve this target. Khan thought this target unlikely, given the continued global economic slowdown and the fact that private sector credit has only increased by \$1.6 billion in the first six months of the Pakistani fiscal year.

¶ 17. (SBU) Khan said that almost every sector of the economy -- from large manufacturing to transport to finance and banking -- is shrinking this fiscal year. Agriculture is the main potential bright spot for GDP growth. Pakistan's current account deficit reached approximately \$6 billion from July-October. Despite lower deficits in October and November, Khan predicted that the current account deficit was likely to be \$12.5-\$13 billion for the year, higher than the IMF goal of \$10 billion.

Stubborn Inflation

¶ 18. (SBU) Khan predicted that sugar and wheat will drive up inflation in Pakistan. The GOP commitment to purchase wheat at the unrealistically high support price of \$297/ton will be a major factor in maintaining Pakistan's 21 percent inflation; since that GOP decision was taken, world wheat prices have fallen to around \$170/ton. Khan asserted that large-scale farmers and importers have taken advantage of the disparity in prices by importing wheat that they will then sell to the government at a high profit. To forestall this windfall, Khan said the GOP might impose a regulatory duty on wheat imports to equalize the price. Khan said the rural poor will survive because they reserve some of the crop for their own consumption. However, the urban poor will be hard hit by higher flour prices.

¶ 19. (SBU) The sugar cane crop is predicted to total approximately 3.6 million tons in 2009 rather than the necessary 4.2 million tons. This means that a kilo of sugar in 2009 could cost almost double what it did in 2008. Septel reports on GOP authorization to allow sugar imports.

¶10. (SBU) Khan expressed confidence that the GOP was sincere in its efforts to meet IMF conditionality. He stressed, however, that the collapse in world agricultural and fuel prices made January 2009 "a different world" from October 2008, when the terms of the Arrangement were being negotiated. Calling the IMF program "essential,⁸ Khan said that it had eliminated much uncertainty in the market and stabilized the Pakistani economy. These gains are fragile, Khan concluded. The GOP will have to work closely with the IMF and others over the next six months to ensure open communication in light of Pakistan's evolving circumstances.

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